INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	3
Specification of errors to be urged	4
Summary of argument	5
Argument	6
I. The taxpayer, since he did not own the oil as produced, or its proceeds, did not receive "gross income from the property"	7
II. The taxpayer acquired no capital interest of any character in the property	11
Conclusion	16

CITATIONS

Cases:

Burnet v. *Logan*, 283 U. S. 404 ..... 5, 12

Consolidated Arizona Smelting Co. v. *Hinchman*, 212 Fed. 813, certiorari denied, 239 U. S. 640 14

Helvering v. *Bankline Oil Co.*, No. 387, October Term, 1937 6

Helvering v. *Elbe Oil Land Development Co.*, No. 446, October Term, 1937 6

Helvering v. *Mountain Producers Corp.*, No. 600, October Term, 1937 6

Helvering v. *Twin Bell Syndicate*, 293 U. S. 312 ..... 7, 10, 11

O'Donnell v. *Commissioner*, 64 F. (2d) 634, certiorari denied, 290 U. S. 699; *ibid*, 25 B. T. A. 956 13

Palmer v. *Bender*, 287 U. S. 551 ..... 5, 7, 9, 10, 15

Richfield Oil Co. v. *Hercules Gasoline Co.*, 112 Cal. App. 431 14

Southwest Pipe Line Co. v. *Empire Natural Gas Co.*, 33 F. (2d) 248; 64 A. L. R. 1229 14

Thomas v. *Perkins*, 301 U. S. 655 ..... 5, 7, 9, 10

Statute:

Revenue Act of 1926, c. 27, 44 Stat. 9, 16, 26:

Sec. 204 2

Sec. 214 3

37478—38——1

Miscellaneous: Page

Mills and Willingham, *Law of Oil and Gas*, pp. 184–185... 14

Thornton's *Law of Oil and Gas*, Vol. 1, Secs. 35, 37, p. 148.. 9, 14

Thompson, *The Modern Law of Real Property*, Vol. 6, Sec. 5131..... 9

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 406

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THOMAS A. O'DONNELL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 47–52) is reported in 32 B. T. A. 1277. The opinion of the Circuit Court of Appeals (R. 85–90) is reported in 90 F. (2d) 907.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 14, 1937 (R. 90). Petition for certiorari was filed September 11, 1937, and was granted October 25, 1937. The jurisdiction of this

Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether one acquires a depletable interest when he sells his stock in one corporation to another which "agrees to pay therefor * * * one-third (⅓) of the *net profits* received by it * * * from the development and operation" of oil leases, which the purchaser corporation agrees to acquire from the first corporation.

STATUTE INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9, 16, 26:

> SEC. 204. * * *
>
> (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—
>
> * * * * * *
>
> (2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if

computed without reference to this paragraph.

SEC. 214 (a) In computing net income there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

STATEMENT

Thomas A. O'Donnell, an oil operator, owned one-third of the capital stock of the San Gabriel Petroleum Company, which he sold to the Petroleum Midway Company, Ltd., by written contract on January 9, 1918 (R. 44).

As consideration for such stock Midway agreed to pay O'Donnell one-third of the *net profits* from the development and operation of the properties enumerated in leases then owned by the San Gabriel Company (R. 78). Midway agreed to acquire all of the assets of the San Gabriel Company and to dissolve it (R. 79).

The contract further provided that in ascertaining net profits, which was to be done quarterly, "there shall be deducted from the gross receipts, in addition to other deductions, a sum of money equal to six (6%) per cent per annum" figured on the net advances made by the Midway Company for the payment of the debts of the San Gabriel Company and for the development of its properties (R. 79).

In accordance with the contract, the Midway Company (name since changed to California Petroleum Corporation of California) acquired all of the assets of the San Gabriel Company and dissolved it, and developed and operated the oil properties thus acquired, and paid respondent one-third of the net profits to August 4, 1926 (R. 44–45). (Subsequent payments were made to Mrs. O'Donnell (R. 46), which the court below held were taxable to her.)

The petition to the Board involved O'Donnell's right to deduct percentage depletion on the payments received by him under the above contract during the years 1925 and 1926 (R. 22). The Board allowed the claimed depletion. The Circuit Court of Appeals affirmed the Board.

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the taxpayer, under his contract with the Midway Company, acquired an economic interest in oil in place.

2. The Circuit Court of Appeals erred in holding that the taxpayer was entitled to a 27½% depletion allowance on the payments he received under his contract with the Midway Company.

SUMMARY OF ARGUMENT

I. The depletion allowance is a percentage of "gross income from the property." Only the owners of oil or gas as produced, or of the gross proceeds thereof, receive gross income from the property and are entitled to participate in the allowance. *Palmer* v. *Bender,* 287 U. S. 551; *Thomas* v. *Perkins,* 301 U. S. 655. In the instant case Midway owned the oil produced. To it belonged the gross proceeds from the sale of the oil. The respondent's interest in the oil in place, or in the oil produced, was no greater—indeed, was less—than if he had been a stockholder in Midway entitled to receive dividends pursuant to a special formula. Midway, which owned the oil produced, was solely entitled as against the respondent to the depletion allowance.

II. The respondent was not only without any interest in the oil but also without interest in the leases or in the lands. The transaction with Midway was a sale of stock in consideration of Midway's promise to pay an indeterminate sum of money, and was so treated by the taxpayer in an earlier litigation. It was not an exchange of property. *Burnet* v. *Logan,* 283 U. S. 404. An agree-

ment to pay over a share of *net* profits from the operation of an oil lease is not an interest in the lease or the land but is a mere personal covenant. The taxpayer, having no capital interest whatsoever in the property is clearly outside the class of "mines, oil and gas wells, other natural deposits and timber" to which the depletion section alone applies.

ARGUMENT

This case is one of four, to be heard consecutively,[1] dealing with related problems concerning the right of a taxpayer under the Revenue Acts of 1926 and 1928 to share in the deduction for percentage depletion granted by the statutes "in the case of * * * oil and gas wells."

In the present case the respondent acquired, in consideration of the sale of shares of corporate stock, the right to receive a specified proportion of the purchaser's net profits, as specially defined in the contract, from the development and operation of certain oil leases which the purchaser agreed to acquire. The court below, we think, erred in holding that sums paid pursuant to this contract are subject to depletion.

---

[1] The other three are No. 387 (*Helvering* v. *Bankline Oil Co.*), No. 446 (*Helvering* v. *Elbe Oil Land Development Co.*), and No. 600 (*Helvering* v. *Mountain Producers Corp.*).

I

THE TAXPAYER, SINCE HE DID NOT OWN THE OIL AS PRODUCED, OR ITS PROCEEDS, DID NOT RECEIVE "GROSS INCOME FROM THE PROPERTY"

The depletion allowance is granted to compensate the taxpayer for the wasting of a capital asset incident to the production of taxable income. An interest in the mineral in place—a capital asset—is therefore a prerequisite of the allowance. This interest, however, need not amount to legal ownership of the mineral content of the land. What is essential is that the taxpayer be entitled to a share of the mineral produced, or of its gross proceeds. *Palmer* v. *Bender,* 287 U. S. 551; *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312; *Thomas* v. *Perkins,* 301 U. S. 655. "If so, he has an economic interest in the oil, in place, which is depleted by production." *Palmer* v. *Bender,* 287 U. S. at 557. It is only owners of gas and oil, *as produced,* who are recipients of "gross income from the property" within the meaning of the statute, and hence entitled to depletion. *Thomas* v. *Perkins,* 301 U. S. at 661.

The court below, relying upon the phrase just quoted from this Court's opinion in *Palmer* v. *Bender, supra,* held that the taxpayer had "an economic interest in the oil in place" since extraction of oil was the ultimate source of the payments, if any, to be made by Midway; and that this interest sufficed to entitled him to participate in the deple-

tion allowance. We think that the court gave to the phrase a meaning not justified by the context in which it was used. The opinion in *Palmer* v. *Bender* was directed to the contention that an assignor of an oil lease who under local law had retained no technical reversionary interest was without that interest in the oil in place which is essential to depletion. The Court held that the right, which the assignors retained, to share in the oil produced constituted an economic interest in the oil in place "which represented their capital investment and was subject to depletion," and that the circumstance, if such it was, that "legal ownership of it [the oil in place], in a technical sense, remained in their lessor" was without significance.

The Court's holding that the right to depletion does not depend upon the precise nature of legal ownership of the oil and gas in place emphasizes, rather than detracts from, its insistence upon the necessity of ownership of the mineral (or its proceeds) as produced. For the one criterion was rejected in favor of the other. The nature of the rights of parties to oil and gas leases in the oil and gas in place is the subject of much conflict and confusion in the holdings of state courts. Federal tax law, the Court held, was not intended to turn upon the niceties of these decisions. The criterion of the right to ownership of the mineral as produced, on the other hand, is subject to no such uncertainties. This element, moreover, the law has always regarded as of cardinal significance. It is everywhere

recognized that the owner even of the fee of oil or gas bearing lands has only a qualified ownership of the minerals in the earth, because of their fugitive nature, which does not become absolute until they are reduced to possession. Thompson, *The Modern Law of Real Property,* Vol. 6, Sec. 5131; Thornton, *The Law of Oil and Gas* (5th ed.), Vol. 1, Secs. 35, 37. The Court held that the existence of this essential right to possession determines the right to depletion; and supported this conclusion by the statement that one who is thus entitled to the oil produced has a capital investment subject to depletion in an economic, whether or not in a legal, sense. Such a holding is a far cry from the proposition that any economic advantage arising out of a contract with an oil and gas operator and depending ultimately upon operation of the well constitutes a depletable interest in the oil and gas in place.

The necessity, under the ruling in *Palmer* v. *Bender,* of ownership of the oil as produced is made clear in this Court's discussion of that case in *Thomas* v. *Perkins, supra,* 301 U. S. at 661:

> Thus in that case we held assignors' mere stipulation for royalty out of *oil* operated to save to them an economic interest in the *oil* sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.* (Italics supplied.)

In the instant case Midway owned the oil produced. To it belonged the gross proceeds from the sale of the oil. By the transfer of his stock the respondent acquired neither the right to share in kind in the oil produced and saved, as in *Palmer* v. *Bender, supra,* nor a right to receive the value in cash of a specified portion of the oil, as in *Helvering* v. *Twin Bell Oil Syndicate, supra*; nor a right to receive a specified amount out of the gross proceeds of the oil, as in *Thomas* v. *Perkins, supra.* His only interest was a right under the contract to receive a specified proportion of Midway's net profits, if any, from operation of the oil leases, to be determined by deducting from its gross receipts not only operating expenses but the stipulated interest payments as well. The respondent's interest in the oil in place, or in the oil produced, was no greater than if he had been a stockholder with an agreement by which dividends were to be declared pursuant to a special formula. Indeed, his interest was less, since his only right was one in current income plus a right to damages in the event of abandonment of the leases by Midway in violation of the agreement (R. 79).

Respondent's "economic interest in the oil," under any view of the phrase, was thus at best contingent and remote. The existence of net profits was dependent upon a congeries of factors beyond his control, in addition to the mere extraction of

oil. The property might be operated to the point of exhaustion without any substantial payments to him. In these circumstances we think it impossible to say that O'Donnell owned the oil or that he received income *from the property*—much less *gross* income from the property—within the meaning of the statute.

We submit that *Helvering* v. *Twin Bell Oil Syndicate, supra,* is a controlling authority that Midway, as against O'Donnell, was entitled to the whole of the depletion allowance. In that case the taxpayer, who operated the property, claimed that the gross proceeds of all the oil produced should furnish the basis for his depletion allowance, without subtraction of the proceeds of royalty oil paid over to the lessor. The Court ruled, however, that the basis for percentage depletion is limited to 100 per cent of "gross income" from the property; that lessors having a right to gross proceeds of a part of the oil produced received "gross income from the property" within the meaning of the statute and were entitled to share in the allowance; and that respondent could deduct only "27½ per cent of the gross income from production which it had the right to retain" (293 U. S. at 321). In the instant case Midway is entitled as against the taxpayer to retain the whole of the gross income, and no basis exists, therefore, for denying it the whole of the depletion allowance.

II

THE TAXPAYER ACQUIRED NO CAPITAL INTEREST OF ANY CHARACTER IN THE PROPERTY

In the petitioner's view the circumstance that the taxpayer had no rights in the oil as produced, or in its proceeds, is decisive against his claim to depletion. Hence he would have no depletable interest even if he were an assignor, entitled to a share of his assignee's net profits. The taxpayer, however, was not only without any interest in the oil but also without interest in the leases or in the lands.

Prior to the transfer of his stock, the taxpayer, of course, had no interest in the lands or leases. He had only a right to receive dividends, if dividends were declared from the profits, if any, of the San Gabriel corporation. The only question therefore concerns the nature of the interest which he *acquired* in the transaction with Midway. This transaction, we think, was a sale of stock by O'Donnell to Midway in consideration of the latter's promise to pay an indeterminate sum of money. It was not an exchange of property. At the time of the transaction, indeed, Midway itself did not own the leases.

The transaction is not distinguishable from that considered in *Burnet* v. *Logan,* 283 U. S. 404. There stock was transferred for cash and a proportionate share of 60 cents per ton of ore apportioned to the purchaser. It was contended that

the receipts under the contract should each year be apportioned to capital and income. This Court said (pp. 412–413):

> The * * * transaction was a sale of stock—not an exchange of property. We are not dealing with royalties or deductions from gross income because of depletion of mining property. * * * As annual payments on account of extracted ore come in they can readily be apportioned first as return of capital and later as profit. * * * She [taxpayer] properly demanded the return of her capital investment before assessment of any taxable profit * * *.

That the present transaction was a sale is a necessary implication from the taxpayer's own contention in a previous litigation. There O'Donnell made the claim that his receipts in 1923 under the present contract constituted a return of capital; and the claim was denied on the ground that the cost of the stock transferred was not in excess of the amounts already received by him prior to 1923. *O'Donnell* v. *Commissioner*, 64 F. (2d) 634, certiorari denied, 290 U. S. 699; S. C., 25 B. T. A. 956, 962. Had the transaction constituted an exchange of the stock for a depletable interest in the oil in place, O'Donnell of course could have made no such claim. The necessity for return of capital before recognition of income imports a sale. It is repugnant to the theory of depletion.

O'Donnell's previous position that the transaction was a sale rather than an exchange was correct,

unless a contract giving the right to a share in net profits resulting from the operation of oil leases creates an interest in the property. Plainly it does not. O'Donnell, of course, acquired no profit *a prendre;* he had no right to go upon the premises to extract the mineral. Compare *Southwest Pipe Line Co.* v. *Empire Natural Gas Co.,* 33 F. (2d) 248, 252 (C. C. A. 8th), 64 A. L. R. 1229; *Richfield Oil Co.* v. *Hercules Gasoline Co.,* 112 Cal. App. 431; Thornton, *Law of Oil and Gas,* Vol. I, p. 148. Midway's promise of a share of its net profits is not a covenant running with the land. Compare *Consolidated Arizona Smelting Co.* v. *Hinchman,* 212 Fed. 813 (C. C. A. 1st), certiorari denied, 239 U. S. 640. Since O'Donnell was an entire stranger to the lease, the payments cannot under any view be regarded as rent. Nor is the promise one to deliver a share of the product of the land, entitling O'Donnell to ownership either of the mineral as produced or of its proceeds. The court below held (R. 89):

> The only right or interest respondent ever had in or under the contract was the right to receive one-third of the net profits from the development and operation of the oil properties.

Such an agreement to pay over a share of *net* profits is not an interest in the lease or the land but is a mere personal covenant. Mills and Willingham, *Law of Oil and Gas,* pp. 184–185:

> An "overriding royalty" is a given percentage of the *gross* production payable to some person other than the lessor or persons

> claiming under him. * * * The provision creates in the owner of such royalty an interest in the lease, cannot be transferred or surrendered except with the same formalities necessary for a transfer of the lease, * * *.
>
> But an agreement to deliver a share of the *net* production, to someone other than the lessor or his assigns, * * * is not a true overriding royalty, is not an interest in the lease or the land, but is a mere personal covenant * * *.

The taxpayer, therefore, had no property interest whatever, either in the land or in the leases or in the oil itself as produced, which was susceptible of depletion. Even assuming that Midway's promise had a market value when given, so that it might have been treated as a capital asset (as to which there is no showing in the record), the statutes afford no justification for regarding a mere personal promise as a depletable interest. Nor do the decisions of this Court furnish any precedent for the anomaly of participation in the depletion allowance by one who under general as well as local law is without any interest in the *property* which is being depleted.[2] O'Donnell, we submit, is clearly outside the class of "mines, oil and gas wells, other natural deposits and timber," to which the depletion section alone applies.

---

[2] The taxpayer in *Palmer* v. *Bender*, *supra*, it should be noted, had under general law an interest in the lease, since he was entitled to share in the product of the land.

CONCLUSION

In view of the foregoing we respectfully submit that the decision of the Circuit Court of Appeals should be reversed.

STANLEY REED,
Solicitor General.
JAMES W. MORRIS,
Assistant Attorney General.
GOLDEN W. BELL,
Assistant Solicitor General.
SEWALL KEY,
A. F. PRESCOTT,
Special Assistants to the Attorney General.
HENRY M. HART, JR.,
Attorney.

JANUARY 1938.

U. S. GOVERNMENT PRINTING OFFICE: 1938